

FUNDS MANAGEMENT: THE COST REDUCTION IMPERATIVE FOR ASSET MANAGERS

02 March 2020 | Global

Legal Briefings - By **Julian Lincoln, David Ryan and Giles Whittaker**

INDUSTRY CHANGE PROVIDES AN INCENTIVE FOR NON-CORE FUNCTION OUTSOURCING

The funds management industry has been experiencing a period of structural change and market volatility which has left institutional investors re-evaluating their preferred operating model. There has been a global trend of bringing core asset and investment management activities in-house, as the industry seeks to address the pressures of rising costs, shrinking margins, increased regulations and rising asset complexity.

Institutional funds, including some of Australia's largest superannuation funds, are seeking to benefit from the enhanced risk management and consolidated investment strategies that are achievable by operating front-office investment management in-house. For example, poor tracking of asset allocation among third party investment managers has in some instances resulted in higher operating costs without tangible benefit - in particular where two external investment funds take equally weighted, but alternative, positions resulting in a net neutral portfolio outcome. Consequently a higher allocation of assets under management is increasing being made to passive funds that are managed in-house and have substantially lower fees than active 'outsourced' funds. In the Australian market, the impact of the Royal Commission is anticipated to result in regulatory change in the funds sector that will impact revenue streams, further driving the imperative to increase operational efficiencies and reduce costs.

THE NEW INVESTMENT OPERATIONS OUTSOURCING (IOO)

As institutional asset managers increasingly focus on in-house management of core investment activities, the trend towards outsourcing of non-core investment operations functions continues to grow. Back office functions such as safe custody and funds administration have long been outsourced to third party providers. Providers in this space have responded to structural change in the funds management industry by developing, middle office outsourcing offerings for functions including data management, portfolio management, reconciliations and reporting, to support asset managers as they seek to reduce costs and operational complexity.

While outsourcing of front-office functions has historically been the domain of smaller funds, we are increasingly seeing market-leading service providers offering outsourcing solutions to large asset managers that extend across the full scope of investment management activities. Providers claim that these 'full' outsourced solutions enable cost savings and operational efficiencies, while also lowering operational and compliance risk, enhancing transparency and improving governance. It remains to be seen whether asset managers in the Australian market will engage with these developing offerings in the context of increasing regulation, industry change and market volatility. To date, superannuation funds including AustralianSuper, Sunsuper and New South Wales Treasury Corporation have sought to implement a 'hybrid' operating model for their core investment management and non-core investment operations functions, by implementing a mix of in-house and outsourced solutions.

KEY IOO CONSIDERATIONS

TARGET OPERATING MODEL

The benefits or limitations of outsourcing depend significantly on the core investment strategy, characteristics and size of an asset manager, and in particular whether economies of scale that can be achieved by implementing an outsourced investment operations solution.

IOO offerings should be assessed and selected based not only on an asset manager's current environment but also with an understanding of the target operating model for the future. Scalability is crucial, especially for larger Australian superannuation funds which in recent years have seen an increase in assets under management and increasing consolidation of sector participants.

REGULATORY COMPLIANCE

Superannuation funds and asset managers are being placed under heightened scrutiny in Australia following the Royal Commission. IOO solutions increasingly have the capability to assist with navigating and complying with regulatory frameworks, allowing asset managers to focus on core investment activities and value realisation. Global regulatory compliance can similarly be supported by outsourcing of non-core functions, and as asset owners deploy funds in global markets the value of outsourcing this aspect of compliance should not be overlooked.

REALISING DATA VALUE

As the funds management regulatory framework becomes increasingly onerous, and asset managers' reliance on real time investment data and technology enabled trading increases, access to a centralised data repository is increasingly critical. Deployment of sophisticated IOO offerings can assist asset managers to both access and use their data in day-to-day operations and realise the full value of their information assets.

Successful outsourcing of investment operations requires stakeholders across an investment business to define core investment strategy, determine a target operating model for non-core investment operations activities, and carefully assess the growing market of IOO offerings. Our experience is that the most successful investment operations outsourcing initiatives are those which have undergone rigorous future-proofing and stress testing to ensure the solution can satisfy both current and future needs.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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